

24 April 2017

Committee Secretary
Joint Standing Committee on Foreign Affairs, Defence and Trade
PO Box 6021
Parliament House
Canberra ACT 2600

Australian Parliamentary Inquiry into Modern Slavery: Supply Chain Audit as a Clause of the Proposed Modern Slavery Act

Dear Sir/Madam

It is a great pleasure to make a submission to your inquiry on modern slavery. I welcome the Joint Standing Committee's inquiry and efforts to identify international best practice for the prevention of modern slavery and human trafficking. For the purposes of this submission, I have limited my comment to areas where I believe my knowledge and experience may assist the committee.

I refer to your term of reference regarding the *identification of international best practice in domestic and global supply chains*. My submission addresses the importance of **effective supply chain auditing** in the establishment of best practice.

Background

I am an Associate Professor and Team Leader of Accounting for the Social and Environmental Sustainability Research Group at QUT. I completed my PhD at RMIT in 2009. Based on interviews with the officials of a global clothing supply industry, MNC managers and their stakeholders, my PhD research has significantly contributed to the understanding of the corporate social disclosure. It has also contributed to policy implications for MNCs and their suppliers operating in a developing nation such as Bangladesh. Since my PhD completion, I have been examining human rights disclosures and transparencies within the global supply chains. Recently, my colleagues from Illinois State University and I completed a project on the corporate disclosure effects of the California Transparency in Supply Chains Act of 2010 in relation to forced labour and human trafficking. My ongoing project is examining social compliance audit practices within the global supply chains. I am the author of a research book '*Social Compliance Accounting: Managing Legitimacy in Global Supply Chains*' (Springer, 2015), and in this book, I have developed the theoretical and practical notion of corporate social compliance auditing. I have edited a research book on '*Sustainability after Rio*' (Emerald, 2015). At the moment, two of my current PhD students are investigating corporate social disclosures and transparency issues. I am a Haskayne Distinguished Visiting Professor at the University of Calgary (2016) and was a distinguished visiting professor at the University of Gadjah Mada (2014). I am a Certified Practising Accountant (CPA Australia) and a Chartered Accountant (CA ANZ). My professional profile and a list of publications are available at <http://staff.qut.edu.au/staff/islam4/>.

Brief Overview of Submission

Despite increasing public concerns over human suffering via modern slavery in the global supply chains, Australia till today has not taken drastic regulatory initiatives to hold its firms and their suppliers accountable. From this perspective, the current parliamentary call is a significant inquiry into possible Australian legislative models around 'modern slavery'. By focussing on Australia's possible legislative model around 'modern

slavery' (in particular within the supply chain) it brings into the spotlight the country's overall approach to tackling this issue. At present, Australia lags behind key jurisdictions such as the United States (Dodd-Frank Act 2012, California Transparency in Supply Chain Act of 2010) and the United Kingdom (The UK Modern Slavery Act 2015), both in terms of the adequacy and enforcement of our modern slavery and human trafficking laws, and in the strength of our commitment to tackling human rights violations in the supply chains.

I support the introduction a Modern Slavery Act in Australia. While this Senate inquiry presents an important opportunity to respond to this situation, by sending a clear message to the lead firms and their suppliers that the Australian government is committed to tackling modern slavery, I will restrict my suggestions to supply chain audits as a possible clause of the new legislative model (the proposed Modern Slavery Act).

Supply Chain Audits

A supply chain audit is associated with social performance standards that a lead company and its supplier/s have to comply with. This is a kind of social compliance audit which assesses specified social performance standards regarding health and safety, working conditions (e.g. use of child labour, forced labour, verbal and physical abuse and so on), or any other social compliance issues prevailing in the plant or supply chain of a company (Islam, 2015). Three basic processes are involved in assessing the social performance of a company that is audited: these are document examination; site inspections; and interviews with senior management, workers, and external stakeholders. Initial audits are conducted to reveal compliance or non-compliance with the specified social standards. The extent of subsequent audits is dependent upon non-compliances identified in the initial audit, or new information received.

When regulators and corporations decide to introduce supply chain audits, they often claim that they are performed for accountability, emancipatory and sustainability reasons, with the goal of advancing society. It is possible, however, that supply chain audits are merely symbolic, and corporations are in fact using them to maintain public relations and maximize profit (Islam, Deegan & Gray, 2015). Supply chain audits can be conducted by an internal auditor, who is an employee of the company, or by an independent third party who may be a consultant, NGO member or public accountant. There are different international voluntary guidelines for social compliance audits and some are supply chain specific (e.g. Social Audit Network, SA 8000, AA1100, ILO workplace standards).

A supply chain audit or social compliance audit is distinctive from a financial audit. Since financial audits focus on financial implications (i.e. profit and loss statements), they do not tell the full story of a company. Supply chain audits, on the other hand, go beyond the financial attention of the company and look at whether and how a company is complying with different social and environmental standards. For example, a financial audit would have a limited scope to explore modern slavery. Therefore, people skilled or experienced with social issues are required to audit companies' social performance and related compliance. In the globalized world where MNCs have their complex supply chain operations in many different countries, "there is clearly as much need for a social (compliance) audit (or a supply chain audit) as for a financial audit" (Zadek et al., 1997, p.17).

Supply Chain Audits and UN/OECD Due Diligence Approach

The UN's endorsement of the Due Diligence Principles for business and human rights (OHCHR, 2011) represents one of the most significant developments in corporate accountability; an audit is the key component of the Due Diligence process. Hand in hand with the UN's endorsement, OECD (2013) adopted a Due Diligence framework which was recommended by Dodd -Frank Act (US SEC's conflict mineral rule 1502,

2012). In particular, the US SEC has instructed companies to follow a nationally or globally acceptable Due Diligence guide, such as Guidance for Responsible Supply Chains from the OECD (Hochfelder, 2014). According to the US SEC rule (section 1502), the Due Diligence procedure requires companies to identify, prevent, mitigate and account for how they take action to mitigate human trafficking and forced labour. Due Diligence guidance is very important because it is an ongoing, proactive and reactive process through which companies can ensure that they respect human rights and do not contribute to adverse human rights impacts (OECD, 2013). The structure of that Due Diligence in the supply chain system is as follows (OECD, 2013):

- launch durable company management systems;
- recognize and evaluate risk in the supply chain;
- plan and implement a tactic to respond to recognised risks;
- undertake independent third-party audits of supply chain Due Diligence at identified points in the supply chain; and
- report on supply chain Due Diligence.

The US SEC's suggestion to use the Due Diligence process is a qualitative and voluntary guideline and there will, therefore, be variations between how companies adopt the Due Diligence process. While auditing and reporting are essential parts of the Due Diligence model, any company which is involved in human rights abuse needs to cooperate in providing remedies to victims, including human rights grievance mechanisms (O'Brien 2013). The Due Diligence approach in relation to slavery and human trafficking in supply chains suggests that the managers concerned, by way of independent supply chain audits, understand whether their suppliers violate human rights through slavery or not.

Concerns over the Supply Chain Audits

While regulators and companies are positive about supply chain audits, critics argue that the way companies use them does not create corporate accountability. In a recent report, PwC notes that supply chain audits are not held in such high regard, with critics often referring to the audit history of factories in the Rana Plaza, Bangladesh, as an example of audit failure (PwC, 2016). PwC also argues that some suppliers exploit weaknesses in audit plans and procedures. Many critics (academics and NGOs) argue that if supply chain audits are simply a part of 'risk management' and a 'profit maximisation' technique, this may not meet the regulatory purpose of the audit given regulators' ultimate purpose is to tackle modern slavery. If an audit is carried out due to self-interest, this may create a dead-end to corporate accountability. Therefore, it is regulators' responsibility to seriously consider whether or not the proposed audit mechanism will be helpful to tackle modern slavery. The irony is despite concerns over the (mis) use of supply chain audits, extant Acts (such as the UK Modern Slavery Act 2015) do not provide effective means by which a supply chain audit is enforced.

Some suggest a solution is external community (or stakeholders) originated supply chain audits rather than the management originated audits. What the extant Acts (such as Dodd-Frank Act) are suggesting, however, is largely management originated third party audits. With respect to management originated audits, the most important component of the UN/OECD Due Diligence approach is the use of independent third party auditors who can be vital in creating change. Even independent third party auditors (if they are not well trained and not independent enough) might find it difficult to trace or identify modern slavery in the complex supply chains. One of the key problems with respect to forced labour is its possible hiddenness and the challenge of detection. A supply chain auditor might encounter substantial levels of vigorous deception and denial from anyone involved in forced labour or slavery, and so the normal use of an audit mechanism might be problematic (New, 2015).

Industry research and investigative news have documented significant audit failures in a voluntary regime. In 2013, the Australian Council of Superannuation Investors (ACSI) surveyed 34 Australian companies and found that despite exponential increases over the last six years in imports from countries with higher human rights risks, and a growing level of consumer awareness of human rights issues, commitments to ongoing audits and corrective action plans were even less frequently addressed and disclosed (ACSI, 2013). Frequent incidents of child labour and poor working conditions call into question the quality of the third party audits that are meant to detect non-compliance (ACSI, 2013). Just after the Rana Plaza disaster in Bangladesh in 2013, the Australian Broadcasting Corporation's (ABC's) Four Corners program travelled to Dhaka (capital of Bangladesh) and revealed that Australian firms, including Rivers, Coles, Target and Kmart, ordered clothes from factories in Bangladesh that did not meet international social compliance standards (ABC, 2013). While clothing production for Australian firms in Bangladesh has increased 1,500 per cent since 2008, the audit became a key mechanism to understand supply factory working conditions in Bangladeshi factories (ABC, 2013). For example, ABC Four Corners highlighted that Kmart's audits revealed workers did not get a living wage and there were issues with child labour. Despite this audit finding, Kmart took three years to drop a supplier facing such an accusation (ABC, 2013).

Audit failures may occur as audit outcomes/results are not followed up or not implemented. ABC's Four Corners also provided insight into how Coles experienced difficulty conducting independent supply chain audits in Bangladesh. After the Rana Plaza tragedy, while only a few Australian firms such as Target, Big W and Wesfarmers were seen to undertake independent audits (Target performed 895 audits in 2012; most were not publicised) (Yenko, 2013), many other retailers may not have any audit mechanism in place and any realistic measures to curb human suffering in the supply chains (Butler, 2013; Whalley, 2013). Our research, an extension of my PhD study, has well documented the failure of supply chain audits by MNCs and their suppliers in Bangladesh (see Islam, Deegan & Gray, 2015). After the Rana Plaza incidents, I undertook follow up interviews (for my ongoing project) with auditors (including those who conducted audits on the suppliers located in the Rana Plaza) and found that MNCs and their suppliers used audits and auditors (including external auditors) who overlooked certain social compliance issues, including forced labour and abuse (both verbal and physical). Audits were irregular; an audit was not performed until the media or NGOs' highlighted negative findings, or until some big accident occurred. Before the Rana Plaza incident, MNCs and their suppliers never used auditors to audit building structures and related safety issues.

There are other problems in a developing nation that auditors can't solve; for example, the misuse of political power by Mr. Rana and the prevalence of bribery by public officials (who were usually bribed to obtain building inspection certificates or environmental certificates) may form part of the history behind the Rana Plaza collapse in Bangladesh. The biggest problem was that, despite their protest, workers were forced to enter the Rana Plaza to start their shifts, despite cracks appearing in its pillars a day before the collapse; in other words, workers, in fact, were forced to die at their workplace. If slavery was stopped, if forced labour was stopped, more than 1,100 workers could have survived the Rana Plaza incident. Given this, I argue that an auditor's role is significant in uncovering slavery and forced labour.

Existing Acts in other Regimes and Concerns over the Application of Supply Chain Audits

There are at least three existing Acts that are relevant to my discussion and these are also aligned with the Act that may be enacted in Australia: California Transparency in Supply Chain Act (2010), Dodd-Frank Act (US SEC's conflict mineral rule 1502, 2012) and the UK Modern Slavery Act (2015). All of these Acts require companies to disclose audits and associated monitoring mechanisms to tackle human suffering in the global supply chains.

The Dodd-Frank Act provides a requirement for companies that file Conflict Mineral Reports with the US SEC (rule 1502) to screen their extended supply chains for conflict minerals. In particular, the US SEC rule 1502 suggests companies adopt the OECD's Due Diligence approach where independent, third party supply chain audits are central to creating corporate transparency. The Act emphasizes the transparency of mineral flows through independent third party audits on all parties and sites in the supply chain so that companies thoroughly respect human rights when sourcing minerals or metals. The US SEC believes that it would be consistent with the independence requirements of Rule 2-01 of Regulation S-X if the issuer's independent professional accountant also completes the independent/third party private sector audit of the Conflict Minerals Report¹. However, critics find limitations in this Act. Companies only relying on supply chain audits in line with the Act may not create substantive value in the face of modern slavery (New, 2015). There is no clear guidance regarding the consequences of non-compliance; there are no clear guidelines regarding what make an auditor qualified, efficient and independent.

The UK Modern Slavery Act 2015 contains a dedicated section on Transparency in Supply Chains for 'commercial organizations' (Part 6 Clause 54), requiring them to annually disclose their Due Diligence efforts to prevent slavery and trafficking on their websites. In relation to audits, an organization's slavery and human trafficking statement may include information about:

- a. the organisation's structure, its business, and its supply chains;
- b. its policies in relation to slavery and human trafficking;
- c. its Due Diligence processes in relation to slavery and human trafficking in its business and supply chains;
- d. the parts of its business and supply chains where there is a risk of slavery and human trafficking taking place, and the steps it has taken to assess and manage that risk; and
- e. its effectiveness in ensuring that slavery and human trafficking is not taking place in its business or supply chains, measured against such performance indicators as it considers appropriate (<http://www.legislation.gov.uk/ukpga/2015/30/section/54/enacted>).

The Modern Slavery Act, in particular, requires companies to disclose efforts to undertake audits of suppliers to assess supplier compliance with recognized standards for human trafficking and slavery in supply chains. It also requires (direct) suppliers to confirm that raw materials used for production comply with the standards regarding slavery and human trafficking of the countries in which they are operating. The Due Diligence guidance needs to be applied as part of assessment and strengthening of slavery and human rights obligations in supplier contracts. Independent third party audits need to be employed to monitor on-going performance. One thing that will drive change, is that the annual modern slavery disclosures from companies will have to be signed off at the board level within a company: as a board's fiduciary responsibility; this will be a powerful motivation for both accuracy and real change in accountability and will no longer be a sidelined corporate social responsibility issue. However, the critics find some limitations with this Act. The supply chain disclosure clause is less likely to prevent lead companies in the UK from profiting from any slave and forced labour used in the production centres abroad by non-UK subsidiaries (The Guardian, 2015a). There are also no legally binding requirements to conduct Due Diligence on supply chains. Literally, a company could publish a disclosure statement saying it is doing absolutely nothing to prevent slavery in its businesses and still be fulfilling its legal obligations (The Guardian, 2015b).

¹ See Conflict minerals: What you need to know about the new disclosure and reporting requirements and how Ernst & Young can help', viewed at: [http://www.ey.com/Publication/vwLUAssets/EY_CnflctMinerals/\\$FILE/EY_ConflictMinerals.pdf](http://www.ey.com/Publication/vwLUAssets/EY_CnflctMinerals/$FILE/EY_ConflictMinerals.pdf)

The supply chain provision or clause within the UK Modern Slavery Act 2015 appears to have been modelled from the California Transparency in Supply Chain Act of 2010. The California Transparency in Supply Chain Act went into effect January 1, 2012, and requires lead firms to disclose their efforts to remove slavery and human trafficking from their production process or supply chains. In particular, those companies must disclose on their website to what extent or whether they conduct audits of suppliers regarding slavery and human trafficking. This disclosure must also specify whether audits are independent and unannounced. The California Transparency in Supply Chain Act is also not flawless. While the Act itself is a major breakthrough in corporate transparency, many companies have failed to comply with the requirement to publish slavery disclosures and there are also questions over whether the steps outlined by lead companies as proof of their efforts to combat slavery – such as undertaking supply chain audits – are actually achieving anything in practice (The Guardian, 2015b). Many lead companies have limited quality of disclosure, which suggests that, without additional rules and extended guidance, the Act alone may not lead to meaningful transparency (Birkey et al., 2016). Critics may also argue that companies are unprepared to respond to the Act.

What is needed?

Given the voluntary nature of corporate social responsibility disclosures in Australia, our companies are reluctant to disclose workplace human rights impacts, including disclosures of forced labour and modern slavery (Islam & Jain, 2013). While supply chain audits and associated human rights disclosures in the supply factories is the cornerstone of corporate accountability and transparency in the era of modern slavery, Australian companies and regulations lag behind the regulatory environment current in other developed nations such as the USA and the UK. What is needed is a law that requires companies doing business in Australia to carry out independent, third party audits on all of the supply chains from which they profit and for which they are responsible. While existing Acts in the USA and the UK suggest carrying out independent third party audits, this may be an ineffective tool for the following reasons:

- An audit can be conducted by an inefficient and incompetent independent person;
- There may be a lack of sincerity by lead firm managers to give adequate attention to the audit and audit results;
- Audits may be conducted occasionally or on an irregular basis, or they may be conducted only when a company faces a crisis (a number of companies began using independent audits right after the Rana Plaza disaster). The companies' audit notions, therefore, do not follow the 'going concern' assumption;
- If audit results reveal non-compliance, there is no follow up;
- As supply chain audits are worker-centred, worker voices need to be heard. But auditors may neglect workers' voices and audit results may not be communicated to the workers. Auditors' rules-based approach (or 'Tick the box' approach) may sometimes undermine the workers' voices and limit the interaction, collective actions, interconnectivity, and dialogue. Auditor's unilateral risk mitigation process does not actually reduce the risk of non-compliance and associated broader stakeholder concerns. Slavery, forced labour and physical or verbal abuse may not be fully discovered until auditors talk to factory workers and the local community or create a dialogic environment where workers are free to talk;
- The cost of supply chain audits (or audit fee) are much higher for suppliers if lead firms shift such costs to the suppliers; and

- It is difficult for auditors to locate or identify forced labour and slavery in the high-risk supply regions. As forced labour and slavery is not a formal basis or not visible in formal employment relationships, identification of it is much harder.

The members of the Committee should keep the above critical points in mind to design an effective third party audit requirement. There is debate over who might be an appropriate independent third party to conduct supply chain audits. In practice, NGOs, private consulting firms, and accounting firms are seen as auditors. I argue, however, that none of these bodies are currently efficient and well trained enough to run the independent audits. While NGOs or private consulting firms may possess more independence (than accountants), and have more experience in dealing with human rights issues, they may lack professionalism; most importantly they may not be organized and disciplined in the right areas to run the audits in a systematic manner. On the other hand, while accountants are disciplined professionals who are experts in financial issues and run financial audits, they lack expertise in human rights issues, and without adequate training in this area, they may not be competent enough to conduct supply chain audits. In other words, accountants could be an interesting group to run supply chain audits if they are given intensive training on morality, ethics and human rights (including human trafficking and slavery). Unfortunately, right now I do not see any other disciplined professionals and systematic and skilled groups who could assist. Therefore, it is a challenge for regulators to identify the appropriate persons/groups/professionals who are well qualified as social compliance or supply chain auditors and who can become part of the process in tackling human suffering in supply chains.

Some researchers talk about community (some may see this as NGOs or civil society) originated supply chain audits, in which independent NGOs or civil society organisations lead the audit to verify a company's supply chain operations; the business community may not accept these community-driven audits. Thus, there is scope for an independent human trafficking or modern slavery commission where all third party auditors (NGO members, private consultants or accountants) can be well trained by human rights experts within the commission. There is scope for collaborative auditing, where NGOs and accountants work together to tackle human trafficking and forced labour. The intention of the Modern Slavery Act may not be achievable if supply chain audits ignore the voices of the victims of slavery. A well trained/educated auditor may be able to capture workers' voices (including the level of violence, abuse and slavery) in his/her audit report and communicate the audit outcomes with the workers (or the victims of slavery) and the broader community. A question for further discussion is: to what extent do we need to educate our tertiary level students to be socially responsible managers, accountants (auditors) and policy makers?

Overall, while the potential Modern Slavery Act in Australia represents a huge step forward in the development of corporate accountability, the country needs to move faster to effectively regulate and respond to modern slavery and become one of the leaders in this area. Australia will not ever begin to eliminate modern slavery unless it ensures that the supply chains of all of its companies, whether operating in Australia or overseas, are not contaminated by human trafficking, slavery, exploitation or verbal or physical abuse.

I trust this submission will assist the Joint Standing Committee.

Yours Faithfully

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